

Recognizing the Right Royalty Rate

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As an attorney who specializes in licensing and who has worked with many inventors and technology start-ups, I enjoy the challenge of helping people bring their technology to market. One challenge my clients often face is how to determine royalty rates for licensing their inventions or other intellectual property.

I start by offering the following fundamental observation:

The licensor needs to know the licensee's business model and profit margin, because the royalty must be less than the licensee's profit.

An article in the September 2006 issues of *les Nouvelles*, a quarterly publication of the Licensing Executives Society International (www.lesi.org), agrees with and expands upon this observation.

"Fair And Reasonable Royalty Rate Determination – When Is The 25% Rule Applicable?" was written by Ove Granstrand, Professor of Industrial Management and Economics at Chalmers University of Technology (Goteborg, Sweden) who was at the Stanford Institute for Economic Policy Research when the article was published.

After presenting several paragraphs of mathematical formulas, Granstrand makes his central point: A fair and reasonable royalty is one where the licensor's share of the licensee's operating profits (i.e., the royalty rate) equals the licensor's share of the combined investment by the licensor and the licensee in research and development, production and marketing the technology.

The licensor's share of the combined investment will depend on the stage of the technology's development. For example, an early-stage company with little more than a patent may count on the licensee to do most of the R&D work and all of the production and marketing, earning the patent-holder a royalty of just a few percent. Conversely, if the licensor has a mature technology in which the licensor has already made substantially all of the required R&D investment (Granstrand suggests that some pharmaceuticals fall into this category), the licensor's royalty might exceed 50%.

Granstrand discusses the well-known "25% rule", which says that the licensee should pay 25% of operating profit (before depreciation and taxes) as a royalty. The author notes that the 25% rule actually is a special case of his general rule. In some situations where the licensor conducts R&D but leaves production and marketing to the licensee, the licensor's share of the total investment will be approximately 25%, so the 25% rule applies.

Of course, reality is more complex than academics' idealized world. For example, the licensed technology may apply to only a component of a finished product, in which case cost and revenue allocations must be considered. Nevertheless, the combined-investment formula remains a useful starting point for establishing royalty rates.

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